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TAGS: ECON EFIN ETRD PREL RS
SUBJECT: PRESSURING RUSSIA ECONOMICALLY: DIFFICULT CHOICES

Classified By: Ambassador John Beyrle, Reasons 1.4 (b/d).

Overview

¶1. (C) As Washington contemplates next steps toward Russia in the aftermath of the conflict with Georgia, including possible economic punishment, the Mission would like to share its perspective. First, the U.S.-Russia economic relationship has been growing fast in recent years and was showing great potential to continue that trend. However, that relationship is more important symbolically than in actual fact. The U.S. trades more with Mexico in a month than with Russia in a year and bilateral direct investment -- perhaps $20 billion -- is very small relative to the size of the economies.

¶2. (C) As a consequence, we have limited direct leverage over Russia's economy. Europe, of course, has more but the Russians clearly do not fear they will use it. We have more leverage indirectly through our influence in the international economic institutions, but the Russian government has already written off WTO for the time being, does not believe we will be able to make good on our threats to kick them out of the G-8, and has no further need of the IMF or World Bank.

¶3. (C) Where we do have real leverage is in the marketplace, which is proving sensitive to the prospect of an extended downturn in U.S.-Russia relations. And the markets are pummeling the Russian economy. The Georgia conflict, following several other incidents (TNK-BP, Mechel), appears to be the final straw for many investors' confidence in the GOR and in its economic policies. It has led to heavy capital flight and rising risk premiums on Russian equities and on Russian borrowing. The long-term consequence is likely to be slower economic growth and lower living standards.

Russian Economic "Highlights"

¶3. (C) Among the economic consequences of the conflict in Georgia, we would highlight the following:

-- Russian stock markets fell more than 10 percent following the invasion. After recovering slightly following the announcement of the cease-fire, they fell again, on the news of Russia's delayed withdrawal, and then again following the decision to recognize Abkhazia and South Ossetia's

independence.

-- Approximately a fourth of the $600 billion loss in shareholder value since May is directly attributable to the Georgian conflict. The markets are now at levels not seen since the fall of 2006 and further losses are likely to follow absent a resolution to the conflict and an easing of tensions with the West.

-- Finance Minister Kudrin admitted that $7 billion left Russia on August 8 alone. One of our contacts estimated a net capital outflow of $15 billion in the first week of the conflict. Another said the outflow was closer to $20 billion.

-- We know from one source in the financial community here that two major institutional U.S. investors decided last week not to invest in Russia, citing the rising risks. The total not invested was in the hundreds of millions of dollars. There are doubtless other examples of opportunity costs to the Russian economy caused by the conflict that we are unaware of.

-- We have also been told that many investors in investment funds active in Russia have given notice of their intention to withdraw their money at the next available moment, the end of the third quarter on October 1. We have been told that the total is likely to be in the billions.

-- The ruble immediately fell 2.5 percent against the dollar following the invasion, its first drop since 2003, and has generally continued to drop since. The Russian Central Bank has already spent $16.4 billion in reserves, that it acknowledged, to prop up the ruble and provide liquidity to the banking sector in an effort to avoid a crisis of confidence.

-- Russia's reserves (which include the Reserve Fund and the National Welfare Fund) fell from $597 billion to $581 billion as a result of these interventions, the first drop in total reserves since 2006, when Russia paid off the last of its IMF debt. Although still large, the reserves must be balanced against Russia's roughly $500 billion in foreign corporate debt, much of it held by state corporations that hope to avoid refinancing at higher rates by accessing the reserves.

Sanctions: A Double-Edged Sword

¶4. (C) Although the U.S. lacks direct leverage over the Russian economy, Russia is much more globally integrated than its government likes to admit. Global markets can punish the GOR and they have reacted very negatively to the conflict. We should draw attention to that reaction and what it may mean for the future of the Russian economy. Moreover, more general sanctions, such as we deploy for instance against Iran, in and of themselves are not likely to affect Russia's commodity exports, which are the foundation of the economy. They will, however, signal continued U.S. disapproval and could, therefore, have a further chilling effect on the global markets' interaction with the Russian economy.

¶5. (C) In addition, sanctions could, no matter how targeted on separatist leaders, put American business and commercial interests at risk. Just one potential example is last year's $3.5 billion deal for Aeroflot to buy 22 Dreamliners from Boeing. The GOR could tear this deal up and purchase planes from Airbus instead, hurting the U.S. and driving a wedge between the U.S. and Europe. Sanctions could also undermine our long-term goal of further global integration for a modernized Russian economy. WTO membership, which would help the pace of promised reforms, is far from a universal aspiration here, and sanctions would remove our remaining moral suasion to pursue accession.

¶6. (C) Russian officials have clearly signaled that U.S. sanctions could provoke a counter-response. In an August 27

conversation with the Ambassador, Deputy Foreign Minister Karasin alluded to "rumors" that Washington may be considering economic sanctions as a policy response. Karasin advised that any such approach should be "thought through carefully" because "certain things will follow" from the Russian side. He pointed specifically to services provided by the Russian Volga-Dnepr company (which provides heavy cargo lift into Afghanistan for the U.S. and other European allies) in that regard.

Comment

¶7. (C) Our strategic goal should remain a more democratic and rules-based Russia that is not isolated from, or hostile to, the West. Further integrating Russia into the global economy is a major component of that goal. U.S. trade and investment and related activities (e.g., business exchanges) have promoted that integration far beyond the modest trade and investment figures mentioned above. While we should support actions to target specific entities or individuals with financial interests tied to Abkhazia and South Ossetia, we must work to limit the fallout and to avoid broader sanctions on economic activity that will have limited effect and, as described above, risk damaging our own interests more than Russia's. End Comment.
BEYRLE